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SENSITIVE
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FOR US EMBASSY PANAMA- PLEASE PASS TO CODEL HAGEL

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SUBJECT: SCENESETTER FOR AUGUST 31-SEPTEMBER 2 VISIT OF
CODEL HAGEL

11. (U) Summary: The relationship between the United States and Brazil is as productive and broad-based as it has ever been, the result of the excellent relationship between President Bush and President Luiz Inacio Lula da Silva, new cooperation mechanisms on biofuels, business issues, and economic matters, and our shared goals of fostering hemispheric stability, promoting democracy, developing a consensus on next steps regarding climate change, and achieving a mutually satisfactory conclusion to the Doha round of WTO negotiations. U.S.-Brazil cooperation on foreign policy issues is often limited by the GOB's unwillingness to speak out against anti-democratic actions in the hemisphere (Venezuela and Cuba), take key steps to address key issues such as nuclear proliferation and counterterrorist concerns, and expand its international leadership in meaningful ways. Operational cooperation on law enforcement issues, such as counternarcotics, container security, and intelligence sharing, are highlights of the bilateral relationship. Brazil's ethanol program has made it a global model for alternative energy and offers potential for bilateral cooperation on an important strategic issue. On the environment, Brazil has long been on the defensive about the ongoing, extensive deforestation of the Amazon, which has made Brazil one of the leading producers of greenhouse gases. The Brazilian labor movement is strong, well-organized, and very influential in many key industrial sectors. Lula came out of the organized labor movement and labor and social issues have always been among his top priorities. End Summary.

Lula Popular, but what comes next?

12. (SBU) With his approval ratings at over 70 percent, President Lula is more popular than at any other point since he took office in 2003. Continuity and legacy are the guiding lights of Lula's second term. Lula continues to shape his legacy as a friend of the poor and builder of a foundation for prosperity for the lower and middle classes through broad social welfare programs and a vast, new economic growth program of public works and growth incentives. At the same time, Lula has failed to promote needed reforms to abolish a political culture of corruption, clientelism, and spoils. Although a seemingly endless series of corruption scandals has not dented his personal popularity or that of his government, these scandals have felled political allies, including cabinet ministers, in recent years.

13. (SBU) Lula is concerned with finding an electable successor for 2010, and appears to be grooming his top domestic policy adviser, Minister Dilma Rousseff, while

keeping other options open. Attention in the media and among the political elite is already focused on the race; the opposition governor of Sao Paulo state and former presidential candidate, Jose Serra, currently leads the pack of possible candidates.

¶4. (U) Despite a healthy economy and a slight drop in homicides registered over the past several years, public opinion polls consistently show that the top concerns for Brazilians continue to remain public security and lack of jobs. These are normally followed by quality of health care and education, corruption, low wages, and lack of opportunities for youth. These will likely remain issues heading into the municipal elections later this year, and into the 2010 presidential elections.

Latin America's Economic Powerhouse

¶5. (U) Brazil is the tenth largest economy in the world, and received investment grade from Standard and Poor,s and Fitch this year. Annual GDP growth was 5.4% for 2007, and inflation approximately 4%. GOB,s inflation target for 2008 is 4.5 percent (current estimated inflation is 6.54%) and the government has taken a hawkish approach to managing interest rates. The SELIC benchrate now stands at 13 percent and market forecasts expect the SELIC could go as high as 15 percent by early 2009. The currency, the real, has appreciated strongly, currently trading at 1.61 as of August ¶12. The probably over-valued real combined with the global slowdown has impacted Brazil,s trade surplus -- for the

BRASILIA 00001151 002 OF 008

first seven months of 2008, Brazil posted a surplus of 14.65 billion USD, down from 23.92 billion the same period in 2007.

While the export sector has been dampened, the strong currency has permitted Brazilian companies to ramp up investment in capital equipment.

¶6. (U) Foreign direct investment in Brazil is increasing, with net flow of USD 34.6 billion in 2007 (versus USD 18.8 billion in 2006). Of total gross inflow of USD 34.3 billion in 2007, USD 6.1 billion came from the United States. Brazilian investment in the United States has almost tripled between 2001 (USD 1.4 billion) and 2006 (USD 3.9 billion). The three key pillars of Lula,s Growth Acceleration Program (PAC) to enhance infrastructure investment in Brazil are energy, transportation and sanitation/housing. GOB recently announced that federal government investment spending from January 2008-May 2008 was 7.43 billion reais, representing a 24 percent increase from the same period one year ago. However, Brazil,s investment to GDP ratio (17.6 percent in 2007) remains well below investment ratios in Russia (21 percent), India (34.6 percent) and China (40.4 percent).

¶7. (SBU) There are other major structural challenges to long-term growth. Real interest rates are the highest in the world at almost 7 percent. Growth-limiting distortions in the economy, including a debt to GDP ratio of 47 percent (2007), a burdensome tax and fiscal structure, and onerous labor and business regulations continue to constrain growth. The informal sector constitutes an estimated 40 percent of the economy, in part due to the tax burden (36 percent of GDP in 2007 and an estimated 38.9 percent first quarter 2008), one of the highest among large developing economies. Brazil is ranked 122 in the Doing Business report (with 152 days to start a business) and ranks 92 out of 125 countries for trade protectionism according to the World Bank. Lula's social programs, combined with formal sector job growth and real increases in the minimum wage, have reduced income inequalities each year since 2004 (2007/08 GINI is 57).

An Emerging Player in the Oil Sector

18. (SBU) The discovery of massive offshore reserves of oil and gas estimated to contain between 30-40 billion barrels of oil equivalent could put Brazil within the top ten oil countries by reserves. Though the possibilities have generated a great deal of excitement, industry observers caution that the technological challenges involved with ultra-deepwater drilling are extensive, including a worldwide shortage of equipment such as drilling rigs, meaning that developments will probably be slow in coming. Petrobras appears to be overextended internationally and is hamstrung by limited equipment resources. However, it has launched a multi-billion dollar procurement initiative and is reexamining its international priorities so that it can focus on domestic opportunities. U.S. oil companies are poised and ready in many cases to take on more exploration opportunities -- a message that we do not believe industry has adequately conveyed to the GOB. Brazil has expressed interest in having U.S. companies involved in the exploitation of Brazil's oil reserves as well as in receiving high-level U.S. visitors with the intention of developing closer bilateral ties.

19. (SBU) Brazil's National Energy Policy Council will meet later this year to consider competing proposals to manage the new "pre-salt" (below the ocean's salt layer at a depth of over 4000 meters) reserves; one would maintain the current concession model and increase royalties, the other would nationalize petroleum reserves and use production sharing agreements or service contracts to partner with oil companies to develop them. Both options would yield similar revenue levels for the government, but political factors will be the driving force behind the decision on a way forward. Mines and Energy Minister Lobao said publicly and in private meetings with high level USG officials that he will propose legislation that will allow the GOB to maintain the rights to the pre-salt reserves. In response to criticisms that the process to rewrite the current law would be too time consuming, he notes that the Executive has fast track legislative measures available to it that should enable the legislation to be enacted early in 2009. The national oil regulatory agency, industry, and analysts disagree and think such a change of legislation would be much more complicated, possibly lasting years, thus their interest in maintaining

BRASILIA 00001151 003 OF 008

the current model. Meanwhile, further leasing of offshore pre-salt exploration blocks has been suspended; other off-shore and on-shore blocks are planned for auction in early 2009. According to Minister Lobao, there will be no new development of the pre-salt reserves for the near future as the GOB defines its approach to the presalt finds, focusing instead on on-shore and shallow water exploration. This is a very sensitive sovereignty issue for the government, featuring minefields of bureaucratic infighting. We have tended to approach the topic by offering the observations of our industry and willingness to share our experiences in this field, if so desired.

Brazil's Nuclear Program

10. (SBU) Brazil has recently announced its intentions to resurrect its long dormant civilian nuclear program. Although Brazil currently only has 2 plants operating in Rio State contributing just 2% to the electrical supply, it has recently announced its intention to complete the third planned reactor and build several new ones. The GOB has expressed interest in working with the United States as they move toward developing their nuclear sector. They have not signed the IAEA Additional protocol, despite our continued urging that they do so but neither have they officially refused. This creates an impediment for Argentina, which like Brazil has a nuclear program and earlier had a weapons program. Argentina will not sign an Additional Protocol until Brazil does. Brazil says it is considering an

Additional Protocol and has not ruled out signing sometime in the near future. Brazil does not currently have an active military nuclear program, having voluntarily closed their program decades ago.

Trade

¶11. (SBU) Brazil has traditionally cited the need to maintain coherence with its Mercosul (known in Spanish as "Mercosur") partners and its role as a leader of the G-20 as constraining its flexibility in trade negotiations. Mercosul is an economic mechanism created for political reasons. However, in what could have been the end-game of the Doha Round, Brazil calculated that the benefits to Brazil of agreeing to compromise in an attempt to achieve a carefully balanced agreement of industrial and agricultural liberalization outweighed the political cost of moving beyond Argentina's preferred negotiating position. This decision drew the praise of industry as well as the think-tank/academic community, which has generally assessed that Brazil's move will not have a long-term negative effect on Brazil's position within the G-20 or Mercosul. Subsequently, President Lula traveled to Argentina with 300 business representatives to smooth relations and demonstrate continued interest in deeper trade and investment ties.

¶12. (SBU) Although Brazil has made clear it will negotiate FTAs or other trade agreements only together with its Mercosul partners, its leadership in Mercosul is key to concluding any agreement. Brazil's continuing emergence as a country willing to engage on trade and other economic issues in its national interest may indicate further potential for expanded interest in economic cooperation with the United States. GOB has made clear its continued interest (and efforts) in concluding a Doha agreement in the near term.

Brazil's Foreign Policy

¶13. (SBU) The United States and Brazil share the basic goals of fostering hemispheric stability, promoting democracy, preventing terrorist and drug transit activity, supporting international non-proliferation regimes, and have been working together to try to achieve a mutually satisfactory conclusion to the Doha round of WTO negotiations. U.S.-Brazil cooperation is often limited by the GOB's unwillingness to take action regarding threats to democracy in specific countries and to support aggressive action in multilateral forums on such issues as non-proliferation, human rights, and democracy. Many Brazilian leaders also take a cautious approach to relations with the United States, sometimes

BRASILIA 00001151 004 OF 008

falling back on shopworn Latin American leftist rhetoric about excessive U.S. influence. Brazil maintains an active dialogue with Venezuela and Cuba, has worked hard to restore relations with Bolivia, and has stood firmly on the principle of respect for sovereignty in responding to the dispute between Colombia and Ecuador, preferring to work through the Organization of American States.

¶14. (SBU) With steady export-led economic growth having become the norm in the recent past, Brazil has been a supporter of reasoned foreign policy goals and has been steadfast in its support of democracy in the hemisphere. The attainment of a permanent seat on the UN Security Council has been a central goal of Brazil's foreign policy under President Lula da Silva's government.

¶15. (SBU) On the Middle East, the GOB is attempting to carve out a more prominent role for itself, although their efforts so far, from the U.S. perspective, have yielded mixed results. Brazil is cautious about taking an active role in

non-proliferation efforts, and has consistently refused to take a strong position against Iran's nuclear efforts. Brazilian officials consider their seat at the table in the Annapolis conference last year as a foreign policy success and see themselves as balanced in their dealings with Israel and the Palestinians, but they have yet to define a substantive role for Brazil.

Military Issues

¶16. (SBU) Brazil established a Ministry of Defense (MOD) for the first time in June 1999, uniting the three services (Army, Navy, and Air Force) under a single minister. Jobim became Minister last year when the disastrous crash of a Brazilian airliner highlighted weaknesses in the civil aviation system, which comes under MOD purview. The Lula administration's focus on social reforms and programs has meant continued lean years for military budgets, leading to fewer training opportunities and equipment purchases. This situation is changing as there is now near consensus among Brazil's leadership that the military is under-resourced and under equipped to accomplish its missions. Decisions on major systems will be influenced much more by access to foreign technology and opportunities for Brazilian industry than by the capabilities such systems will add to Brazil's military. The Lula government has tasked a new National Defense strategy to be completed by this fall to provide a framework for defense modernization.

¶17. (U) Brazil has advocated a South American Defense Ministers Council to provide a forum for exchanges on defense issues. Other governments have expressed willingness to participate but are concerned that the new Council not duplicate such existing institutions as the OAS.

The Bilateral Relationship

¶18. (SBU) The Brazilian public has a mixed view of the United States. Seventy-five percent say relations between Brazil and the United States are very good or fairly good, and Brazilians by a wide margin consider the United States the most important country in the region for Brazil. Those who follow the news know that U.S.-Brazil cooperation on trade issues has global importance and new areas of cooperation such as biofuels are potentially significant. There has been a much more positive view of U.S.-Brazil cooperation since the signing of the biofuels MOU last year. On the other hand, there is a good deal of skepticism about U.S. foreign policy, particularly on issues such as Iraq and Cuba. There is resentment over the long wait times for U.S. visa applications (which the USG is now making an all-out "surge" effort to reduce), a product of a spike in demand without commensurate increases in staffing. There is also an unfounded fear that the U.S. or other foreigners want to take over or internationalize the Amazon.

The Bilateral Relationship: Expanding Economic Cooperation

¶19. (SBU) We continue to seek opportunities for positive

BRASILIA 00001151 005 OF 008

bilateral cooperation through mechanisms including the Economic Policy Dialogue (EPD), the second session of which was held March 6 in Washington. The EPD provides an important opportunity to reinforce our view of Brazil as partner in areas of mutual interest. Cooperation to foster innovation and agricultural coordination, to possibly include assistance to African countries, are new topics of conversation bilaterally. Additionally, we have been working to develop a regional infrastructure initiative. We have

been exploring one another's regulatory frameworks in hopes of addressing barriers and achieving a Bilateral Tax Treaty and a Bilateral Investment Treaty. Brazil has been a significant leader in WTO Doha Round negotiations, opting to focus on its own national interest in supporting a compromise solution, despite the resistance of its Mercosul (Argentina) and G-20 developing country partners (India and China) and leading the charge to try to move beyond the apparent dissolution of the round to try to salvage the work done so far, hoping to move toward a successful conclusion.

The Bilateral Relationship: Law Enforcement Cooperation

120. (SBU) Cooperation on security and law enforcement issues is a highlight of the bilateral relationship, and a potential area for increased cooperation as public security is frequently cited in opinion polls as the most pressing concern for Brazilians. This concern reflects distressing crime statistics, including a murder rate on the order of 25 per 100,000 people, over four times the murder rate in the United States (5.7 per 100,000 in 2006). Newspapers earlier this year trumpeted the headline that total homicides during the last 30 years are approaching the staggering figure of 1 million (compared with a little over 500,000 for the U.S. in the same time period). Since 1991, homicide trends in Brazil and the United States have taken opposite courses: through 2006 the number of homicides in the U.S. had dropped 31 percent, while Brazil's rate increased 51 percent.

121. (SBU) The newly arrived Resident Legal Advisor is working in support of USG law enforcement agencies and the political and economic sections to expand and intensify our relations with the judiciary, prosecutors, and Brazilian law enforcement. We hope this year to seat another Brazilian observer at JIATF-S. Also, the GOB has expressed interest in negotiating a General Security of Information Agreement (GSOIA). The Narcotics Affairs Section (NAS) just signed a new Letter of Agreement with the GOB, which will allow us to move forward to expand cooperation on counternarcotics and countercrime issues, including at the state level. Brazil has been a valuable partner in the efforts to secure our own borders against terrorism through its support for DHS's Container Security Initiative (CSI), its implementation of enhanced passenger screening at airports and its fulfillment of the International Maritime Organization (IMO) ISPS code on port and ship security. Immigration and Customs Enforcement (ICE) is also currently working with the Brazilian authorities to detect financial and smuggling violations, financial crimes and commercial fraud with the assistance of the Trade Transparency Unit (TTU) initiative.

122. (SBU) Department of Homeland Security Secretary Michael Chertoff's July 2008 visit to Brazil provided the latest stimulus to an improved relationship in the area of law enforcement and security between the United States and Brazil, highlighting new areas of cooperation. The visit succeeded in indentifying potentially fruitful new areas for cooperation in the areas of cyber-crimes, infrastructure protection, and port security.

The Bilateral Relationship: Counterterrorism Cooperation

123. (SBU) Although senior policy levels of the GOB have not publicly endorsed U.S. counterterrorism initiatives, cooperation on counterterrorism matters is good at the operational level. The Lula administration just restructured its intelligence apparatus to beef up the counterterrorism focus. Brazil has no legislation outlawing terrorist-related activity or financing of such activity.

124. (U) The governments of Argentina, Brazil, and Paraguay have long been concerned over illicit activities in the

tri-border area (TBA) joining Foz de Iguacu in Brazil, Ciudad del Este in Paraguay, and Puerto Iguazu in Argentina. This TBA concentrates a range of organized criminal activities, including arms and narcotics trafficking, document fraud, money laundering, as well as the manufacture and movement of contraband goods. A wide variety of counterfeit goods, including cigarettes, CDs, DVDs, and computer software, are moved from Asia into Paraguay and transported primarily across the border into Brazil. This inflow of illicit goods stands to be increased with the potential passage of legislation that purports to ease customs procedures for small-scale importers but, due to a lack of enforcement provisions, would likely serve to abet traffickers. The United States remains concerned that Hizballah and HAMAS are raising funds in the area by participating in illicit activities and soliciting donations from extremists within the sizable Muslim communities in the region. The GOB publicly downplays the possibility of terrorist fund-raising inside Brazil and does not consider Hizballah or HAMAS to be terrorist organizations.

¶25. (U) In the 1990s, the three governments established a mechanism, which the USG joined in 2002 at their invitation, to address illicit activities in the TBA. The "3 1 Group on Tri-border Area Security" is intended to improve the capabilities of the three TBA states to thwart cross-border criminal activity and potential terrorist fundraising activity. Brazil is an active partner within this mechanism, but the effectiveness of this group is hampered by GOB denials of any potential terrorist activity taking place in their territory. The suggestion that planning for the 1994 bombing of AMIA, an Argentine Jewish center, might have taken place in Brazil caused the GOB to abstain in an international vote over whether to issue Interpol warrants for Iranian officials accused in the case, an action that disappointed and irritated Argentina. Nonetheless, Brazil has established and hosts a Joint Intelligence Center (JIC) in Foz de Iguacu to combat transnational criminal activity, although staffing issues on the part of Argentina and Paraguay continue to impede its full functioning.

The Bilateral Relationship: Biofuels Cooperation

¶26. (SBU) Brazil has transformed a 1970s program to bolster its large sugar-cane sector into a remarkable showcase for biofuels. The success of Brazil's ethanol program has made it a model for the world in terms of alternative energy and presents the potential for bilateral cooperation on an important strategic issue. Brazil's comparative advantage is its ability to produce huge quantities of sugarcane, which is currently the most efficient feedstock for ethanol. Cane requires far less processing than corn to produce ethanol. According to the World Bank, at current prices, Brazil can make ethanol for about one US dollar per gallon, compared with the international price of about USD 1.50 per gallon for gasoline.

¶27. (U) The ethanol industry in Brazil continues to grow. Petrobras just announced the formation of a new biofuels company. In the coming year alone, Brazil's production of sugarcane-based ethanol is projected to increase 14.8 percent. On the demand side, Brazil's use of modest tax breaks have led new car purchasers to opt overwhelmingly for "flex-fuel" cars that can run on either gasoline, ethanol, or any combination of the two. This year ethanol surpassed gasoline as the major automotive fuel. Domestic demand consumes 85 percent of all production. The other 15 percent is exported, primarily to the United States. The ethanol private sector is increasingly partnering with international companies in building production facilities, as well as addressing the internal logistics problems that undermine the profitability of ethanol exports. These include infrastructure bottlenecks in Brazil as well as various international tariff regimes.

128. (SBU) Following the signing of the MOU in March 2007, Brazil and the United States have been seeking ways to increase our collaboration in order to develop the next generation of biofuels, as well as in developing international standards on biofuels which should facilitate their greater international acceptance and use. The biofuels initiative has provided the groundwork for increasingly positive bilateral relations and has produced some notable

BRASILIA 00001151 007 OF 008

results, including a model for biofuels standard regimes internationally and cooperative efforts to aid Haiti, El Salvador, St. Kitts and Nevis, and the Dominican Republic in developing their own ethanol capacity, and now looking to identify a new tranche of countries for further cooperation. The GOB and USG are pursuing cooperative scientific activities to develop the next generation of biofuels. The more numerous and often better-funded U.S. scientists and laboratories can benefit from this cooperation with Brazil's world-class cadre of scientists and laboratories, which have established an impressive record over the last 30 years. Although the general relationship under the MOU has been constructive and positive, there has been some increased tension recently over public statements by some GOB officials, including President Lula, differentiating between corn and sugar-based ethanol and placing the blame for the food for fuel crisis on corn based ethanol production.

129. (U) One interesting area that may be a potential focus for future collaboration is bioelectricity, which has been touted as the short-term solution to Brazil's potential electricity shortages. It is a clean source of electricity that requires little start-up time and is complementary to Brazil's predominately hydroelectric generation. Bioelectricity production in Brazil is likely to increase as it provides another revenue stream for sugar and ethanol producers and ultimately may be the decisive factor in determining which operators stay in business. There are prime opportunities for U.S.-Brazil bilateral cooperation on technological development in gasification that would advance the market for both biomass products.

Extreme Sensitivity on Sovereignty

130. (U) There is long-standing and widespread fear among Brazilians that the United States or other foreigners want to take over or internationalize the Amazon. Although demonstrably unfounded, it surfaces regularly in official and media circles, as with President Lula's recent assertions that "The Amazon has an owner." More recently, the prospect of enormous oil reserves off Brazil's coast have added new fears that the United States or others might have designs on these, as well. Some Brazilians have linked the just-announced re-establishment of the U.S. Fourth Fleet to these Brazilian oil discoveries. Many Brazilians have expressed concern over the fleet, including Foreign Minister Amorim and four members of the Senate Foreign Affairs and National Defense Committee, who visited Ambassador Sobel on July 9 to express objections to the re-establishment of the Fourth Fleet. Ambassador Sobel has stressed that no ships are assigned permanently to the Fleet, it is not being reactivated with an offensive purpose, and ships assigned to it would not come into Brazilian waters without Brazilian permission. Its main missions will be support of peacekeeping operations, such as in Haiti, respond to natural disasters, such as Hurricane Felix in Nicaragua, organize humanitarian relief, typically of a medical nature, and assist counternarcotics efforts. Standing up the Fourth Fleet intends to demonstrate the priority the United States places on its partnerships in Latin America and will help ensure that Latin America remains a high priority for U.S. engagement. Post has been conducting an information campaign

on the Fourth Fleet and is continuing to do all it can to dispel any myths so that misconceptions about the Fourth Fleet do not take hold, though the issue could come up during the course of your meetings.

¶31. (U) Defense Minister Nelson Jobim stated publicly in early June that Brazil needed to improve security for its off-shore oil resources and that, as permitted by the UN Convention on the Law of the Sea (UNCLOS), Brazil was planning to increase the 200-mile exclusive economic zone to 350 miles to include the Santos basin and other oil deposits located on Brazil's continental shelf. Although there were suggestions in the press that the United States might not respect such an extension because we have not ratified UNCLOS, the United States does fully respect exclusive economic zones established pursuant to customary international law as reflected in UNCLOS. Furthermore, the US has established its own exclusive economic zone according to the same customary international law. UNCLOS recognizes the sovereign rights of a coastal State over its continental

BRASILIA 00001151 008 OF 008

shelf, which extends out to 200 nautical miles--and beyond, if it meets specific criteria. These rights include sovereign rights for the purpose of exploring the continental shelf and exploiting its natural resources, including oil, gas, and other energy resources.

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